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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1956

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

P. G. LAKE, INC.,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

HARRY C. WEEKS
525 The Fort Worth National
Bank Building
Fort Worth, Texas
Attorney for Respondent

Of Counsel:
WEEKS, BIRD, CANNON & APPLEMAN
Fort Worth, Texas

COMMERCIAL RECORDER, FORT WORTH, TEXAS 5-14-57 60

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 241 F. 2d 71. The opinion of the Tax Court is reported at 24 T.C. 1016.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. Petitioner invoked the jurisdiction of this court under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Is the gain received by the respondent, P. G. Lake, Inc., for the sale of a limited overriding royalty or oil-payment interest out of two commercial oil and gas leases which the respondent had held for several years for productive use in its trade or business of producing oil, and not for sale, to be taxed as long-term capital gain, as was held below; or as ordinary income subject to depletion, as the Commissioner of Internal Revenue unsuccessfully contended below?

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are set forth in Appendix A, *infra*, pages 28 to 35. They are as follows: Section 23(m); Section 114(b)(3); and Section 117(a)(1) and (4), (b) and (j)(1) and (2), of the 1939 Code.

STATEMENT

Respondent, P. G. Lake, Inc., is a corporation engaged in the business of producing oil and gas. The transaction in question occurred on December 29, 1950. On that date, P. G. Lake, Inc., in consideration

of the cancellation of an indebtedness of $600,000 owed by it to its president, P. G. Lake, conveyed a limited overriding royalty or oil-payment interest to Lake out of two commercial oil and gas leases which the company had owned for several years and had held for productive use in its trade or business of producing oil, and not for sale. (R. 30-31).

This instrument conveyed to the grantee, "such an interest in said oil and gas leases and each of them, so that the said P. G. Lake, Grantee, shall own twenty-five per cent of seven-eights (25% of 7/8ths) of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive twenty-five per cent of seven-eighths (25% of 7/8th) of all the oil, gas and other minerals produced, saved and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest the sum of $600,000 net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum payable monthly on the entire balance of said original sum remaining from month to month unsatisfied." (R. 33) The entire instrument, omitting field notes, signatures and acknowledgments (R. 32-35 is shown in a footnote[1] to this statement.

Footnote: [1]
STATE OF TEXAS
COUNTY OF SMITH

WHEREAS, P. G. Lake, Inc., a corporation, is the owner of certain oil, gas and mineral leases located in Gregg and Rusk Counties, Texas, and briefly described as follows:

Lease No. 1

A certain oil, gas and mineral lease known as the Mrs. V. E. Reid Lease, and covering the following described property located in Rusk County, Texas, to wit:

(Field notes omitted)

Lease No. 2

A certain oil, gas and mineral lease given by J. P. Owens and wife Willie Owens to J. A. Reynolds, on August 1, 1930, and duly recorded in Volume 78, page 394, Gregg County Deed Records, and which oil and gas lease covered certain lands located in David Meredith Survey, Abstract 131, and the Charles P. Hereford Survey, Abstract 106, located in Gregg County, Texas, the properties covered by said oil and gas lease, by a recent survey of same, being described as follows:

(Field notes omitted)

NOW, THEREFORE, KNOW ALL MEN BY THESE PRESENTS:

That P. G. Lake, Inc., acting herein by and through its proper officers, thereunto duly authorized by a resolution of its Board of Directors hereunto duly passed and entered, hereinafter referred to as Grantor, for and in consideration of the sum of Ten Dollars ($10) and other good and valuable consideration to it in hand paid by P. G. Lake, hereinafter referred to as Grantee, the receipt of which is hereby acknowledged, does hereby Bargain, Sell, Assign and Convey unto the said Grantee, his heirs and assigns, such an interest in said oil and gas leases, and each of them, so that the said P. G. Lake, Grantee, shall own twenty-five per cent of seven-eights (25% of 7/8ths) of all the oil, gas and other minerals produced, saved and marketed from the above described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said Grantee, his heirs and assigns, shall have received by virtue of this interest

the sum of Six Hundred Thousand Dollars ($600,000), net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum payable monthly on the entire unpaid balance of said original sum remaining from month to month unsatisfied.

The 25% of 7/8ths of the oil and gas thereby assigned to said Grantee shall be forever free and clear of any expense of developing, maintaining or operating said leasehold estates, and all costs of producing and marketing said products shall be borne by Grantor, and Grantor shall save and hold Grantee forever harmless of any such costs. Grantor shall likewise promptly pay off and discharge all ad valorem taxes that may be assessed against the interest hereby conveyed to Grantee, and the proceeds of said 25% of 7/8ths of the gross production shall be paid directly to the said Grantee, his heirs and assigns, by any pipe line company or other purchaser of oil or gas from said premises.

The parties hereto shall, from time to time, execute such transfer orders, division orders, or instruments of like character necessary in order to carry into effect the terms and provisions of this conveyance and to facilitate the orderly handling, transportation and sale of the oil and gas produced from said leases.

And when the Grantee shall have received the full net sum of $600,000 plus an amount equal to interest thereon as hereinabove provided for, from the proceeds of the sale of 25% of 7/8ths of all of the oil and gas produced and saved from the above described leases, then this conveyance shall terminate and the interest hereby assigned shall revert to and revest in the Grantor, its successors and assigns, and Grantee shall execute and deliver an instrument of reconveyance of said interest, and any such other papers as may be necessary to replace the title in Grantor.

TO HAVE AND TO HOLD the above described interest unto the said P. G. Lake, his heirs and assigns, forever, subject to the terms and conditions of this conveyance.

In accordance with the terms of the conveyance, transfer orders in the usual form were executed and delivered to the pipe line companies which were then running and purchasing the oil produced from said properties. These transfer orders (introduced in evidence in the Tax Court as the taxpayer's exhibits 2 and 3, R. 28, but by stipulation transmitted to the Court below in original form and not printed in the record, R. 92-93) recognized the ownership by P. G. Lake of the percentage of the oil and gas specified, and directed that he be paid the purchase price of that share of oil and gas until he had so received oil and gas of the value specified in said conveyance. This was done. In February 1954, P. G. Lake had received oil and gas of the specified value and he then executed and delivered to P. G. Lake, Inc. an instrument evidencing this. (R. 35-36).

It could have been estimated with reasonable accuracy on December 29, 1950 that it would require three years or more for the said oil and gas leases to produce sufficient quantities of oil and gas so that 25% of 7/8ths thereof would have a value equal to the

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This instruments is executed in duplicate, each of which, for the purpose of filing, shall be considered as an original. This is done to facilitate filing both in Gregg County and Rusk County.

IN TESTIMONY WHEREOF, P. G. Lake, Inc. has caused this instrument to be executed by its Vice-President, attested by the Secretary, and the corporate seal affixed thereto, this the 29th day of December, 1950.

(Signatures and Acknowledgments Omitted.)

amount of oil and gas to which P. G. Lake was entitled under the conveyance. (R. 36).

P. G. Lake, Inc. reported this transaction in its 1950 income and excess profits tax return, as one producing long-term capital gain in the amount of the consideration ($600,000) less $660, representing the cost of United States documentary stamps affixed to the instrument. (R. 36). Upon reviewing this tax return, the Commissioner of Internal Revenue determined:

> "The $599,340 represents net amount received from sale of oil payment to P. G. Lake in December 1950. The amount is reported on return as sale of capital assets. It is held to be the advance sale of oil and taxable as ordinary income in accordance with General Counsel's Memo 24849, Internal Revenue Cumulative Bulletin 1946-1, p. 66. Depletion is allowed on this income in adjustment (d) below." (R. 36-37).

P. G. Lake, Inc. sought a review of this determination by the Tax Court of the United States, alleging that the gain in question was taxable as long-term capital gain under Section 117 of the Internal Revenue Code of 1939. (R. 5). In a unanimous opinion reviewed by the entire Tax Court, it was held that the gain was taxable as long-term capital gain. (R. 52-60). On the Commissioner's petition for review by the United States Court of Appeals for the Fifth Circuit, the Tax Court was affirmed. (Petition for Certiorari, pages 69 and 107).

REASONS WHY THE PETITION FOR CERTIORARI SHOULD BE DENIED

The petition assigns as the reasons why the writ should be granted:

1. A conflict, primarily with *Commissioner v. Slagter*, 228 F. 2d 901, decided by the United States Court of Appeals for the Seventh Circuit on November 29, 1956;

2. That the holding below was erroneous; and

3. That an important tax question is presented which should be decided by this Court.

After a preliminary discussion, we shall reply to these points in their reverse order.

Preliminary

While the business of producing oil and gas bears some resemblance to a manufacturing business, it is in truth *sui generis*. The right to explore for and produce oil or gas, sometimes termed "oil and gas in place" is everywhere recognized as a valuable property right. Oil and gas when severed by production constitute income, so that the full value thereof, or the amount realized therefrom, constitutes taxable income, from which only such items as the grace of Congress specifies can be deducted in determining the amount

taxable as net income.[2] Thus, since an oil or gas reserve is irreplaceable, the conduct of an oil or gas producing operation to exhaustion destroys the capital initially represented by the oil and gas reserve. Only as to the production of natural resources is such a tax theory applicable.

To ameliorate the hardship of such a taxing theory, Congress, in addition to allowing the oil producer to deduct expense outlays, has granted a deduction for depletion which is based on cost of the reserve or, since 1926, on a percentage of the gross income derived from production. The latter, "percentage depletion," is the more commonly used. This allowance is 27½% of the "gross income from the property" but not more than 50% of the net income therefrom calculated without the depletion allowance.[3]

A long line of cases by this Court has firmly established the principle that this depletion allowance, which in the aggregate can never exceed 27½% of the gross income from the property,[4] must be allocated among all those who by virtue of an economic interest share in the production or the proceeds thereof, whether this interest is because of fee ownership,

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[2] Merten's Law of Federal Income Taxation, Vol. 4, para. 24.02, and cases cited in footnotes 3 and 5, including *Anderson v. Helvering*, 310 U.S. 404, 407.

[3] Sec. 114(b)(3), I.R.C. 1939, Appendix, *infra*, p. 35. There has been substantially no change in this provision since 1926.

[4] *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312.

a royalty or unlimited overriding royalty interest, a lessees interest, a "net profit" interest, or a limited overriding royalty or oil-payment interest.[5]

Both expressed and implied in the depletion decisions, is the related principle that "gross income from property" upon which one taxpayer's depletion allowance is based is a part of that taxpayer's gross income for all other income tax purposes and cannot be a part of any other taxpayer's taxable income from the property.[6]

It has been necessary, in administersing the various Acts, to apply these principles to many different types of transactions. Two particularly pertinent here are: (1) The sale of the property, with the seller reserving a share of the oil or gas to be produced during the life of the property or until oil or gas of a specified amount or of a specified value has been produced; and (ii), the assignment by the owner of a property to another, of one or the other of such interests. These interests are usually called overriding royalty inter-

[5] The latest holding by this Court is *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308; others include *Thomas v. Perkins*, 310 U.S. 655; *Kirby Pet. Co. v. Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25.

[6] See cases cited in footnote 5, and *Anderson v. Helvering*, 310 U.S. 404, which establishes the principle that receipts applicable to a reserved oil payment, so called, which could be satisfied otherwise than from oil and gas when, as and if produced was not a depletable interest so that receipts were the income of the assignee who acquired the properties.

ests where they are to continue for the productive life of the property, and limited overriding royalty or oil-payment interests where they are limited by value or amount to a probable shorter duration. Those arising under method (i) above are ordinarily called "retained" and those arising under method (ii) "carved out."

For many years the Internal Revenue Service made no distinction between such "retained" and "carved-out" interests. All were recognized as "depletable" interests. Other statutory requirements (holding period, etc.) being present, the carving-out of any such interest for a consideration was held to produce long-term capital gain, as was the disposition of such a retained interest. In 1946, with no statutory change and with no Congressional or judicial disapproval of the existing practice,[7] a General Counsel's Memorandum attempted to change the applicability of these established principles as to the taxation of the gain from the disposition of "short-lived" carved-out oil payments only, by ruling that this gain was taxable as ordinary depletable income (provided the proceeds were not pledged to the development of the property, in which case the position of the Service was, and is,

[7] That such a carving out was a sale of an interest in the property and not productive of ordinary depletable income, had been expressly held in *Ortiz Oil Co. v. Commissioner*, 37 B.T.A. 656 (1938), affd. 102 F. 2d 508 (1939), cer. den. 308 U.S. 566, discussed at p. 25, *infra*.

that no income was received). Later, the rule was extended to any carved-out oil payment which did not extend for the probable life of the property and was, therefore, not an overriding royalty interest.[9] These rulings provoked the controversy now before the Court. But no change was, or even has been made, in the treatment of overriding royalties, retained or carved-out, or of retained oil payments.[10] So the po-

[9] *G.C.M. 24,849* 1946-1 C.B. p. 66, reproduced in full in the Appendix, infra, pp. 36 to 42. Particular attention is directed to the statements that a "short-lived" oil payment "ordinarily pay(s) out and expire(s) within one or two years"; that all oil payments are depletable economic interests in the property; and that "The issue presented * * * should not be confused with the question presented in such cases as *Lucas v. Earl* (281 U.S. 111), *Helvering v. Horst* (311 U.S. 112) and *Helvering v. Eubank* (311 U.S. 122), involving donative assignments of income * * *. There the earner-assignor attempts to avoid realization of expected income. Here the assignor expedites such realization."

I.T. 4003, Cumulative Buletin 1950-1, p. 10, reproduced in full in the Appendix, p. 42 *infra*. In *G.C.M. 24,849* (see footnote 8, *supra*, no opinion was "expressed with respect of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved." But four years later, with no citation of authority, judicial or legislative, the rule was announced that "there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights.

[10] Certain principles will not be questioned by the Commissioner or his counsel. They are being applied every day in the administration of the tax laws and are universally accepted. Among them are these:

(i) The assignment of an oil and gas lease, with an overriding royalty retained, is treated as a sub-lease. The cash consideration is treated as ordinary depletable

sition of the Commissioner here must be that he has the right *sua sponte*, to change the administrative practice which had received Congressional and judicial approval, and to hold that the mere fact that the carved-out interest is limited by some standard other than the economic life of the property makes such a carving-out transaction, and that transaction alone, something other than a sale of property; at the same

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income. The overriding royalty is a depletable economic interest.

(ii) The assignment of an oil and gas lease, with a limited overriding royalty, or oil payment, retained, is treated as a sale of a part of the lease. The consideration is not depletable income but sale proceeds taxable as capital gain if the other statutory requirements are met. The oil payment is a depletable economic interest.

(iii) The assignment of the retained overriding royalty (example (i) above) or the retained oil payment (example (ii) above), or an interest in either co-extensive with its remaining life, is a sale producing non-depletable income taxable as capital gain if other statutory requirements are met. The assignee acquires a depletable economic interest.

(iv) The carving out and sale of an overriding royalty produces non-depletable income taxable as capital gain if other statutory requirements are met—as does any subsequent sale of the carved-out interest or a part thereof co-extensive with its remaining life.

(v) Irrespective of how the point involved in the present controversy (the treatment of the consideration received for a carved-out oil payment) may be decided, subsequent assignments of the carved-out oil payment or an interest therein co-extensive with its remaining life produce non-depletable income taxable as capital gain if other statutory requirements are met.

time recognizing that the carving-out of an unlimited overriding royalty is such a sale.[11]

1.

As To the Importance of the Question

The assertion (Petition for Certiorari, p. 21) that there will be an "estimated loss to the revenue of many millions of dollars" if the decision below is permitted to stand is challenged.

Practically every tax rule is a two-edged sword—a tax burden imposed thereby on one opens the way for tax relief to another. So here. If the sale of an oil payment is taxed as a capital-gain transaction, the gain is not depletable income to the seller, nor does it enter into his calculation of the 50% limitation on allowable depletion. (See Section 114(b)(3), I.R.C. of 1939, *infra* p. 35). But under the principle advocated by the Commissioner, the proceeds of such a sale are, in their entirety, treated as depletable income and they enter into calculation of the 50% limitation on allowable percentage depletion. Thus, it is possible under the Commissioner's theory—particularly as to a property in the development stage with resultant large deductions for development expenditures—to bring into a particular year, income which

[11] That the Commissioner does not have the right to change long-continued administrative practices without Congressional approval was expressly held by this Court in a very similar situation. *U. S. v. Leslie Salt Company*, 350 U.S. 383.

would ordinarily be realized in later years and thereby obtain the full depletion allowance on that income plus the normal income from the property for the year; whereas, if G.C.M. 24,849 is inapplicable, the depletion on the normal income for the year would be lost because of the 50% limitation. Only to the Commissioner are data available to calculate how much the revenue suffers from use by taxpayers of his theory, but it is confidently asserted that it equals the "many millions of dollars" which he asserts will be lost to the revenue by the application of the capital gain theory which he here opposes. The "43 docketed and undocketed cases" presenting the capital gain issue (Petition for Certiorari, p. 21) is an insignificant number when considered in connection with the number of taxpayers engaged in producing oil and gas. Nor should it be forgotten that an express purpose of the capital-gain section is to reduce taxes.[12]

2.

The Holding Below Was Correct

Texas law with respect to the nature of the interest created by an oil and gas lease and as the ownership of oil and gas in place, while furnishing cogent reasons for the applicability of the capital-gain sec-

[12] "The exemption of income devoted to charity *and the reduction of the tax on capital gains were liberalizations of the law in the taxpayer's favor*, were begotten from motives of public policy, and *are not to be narrowly construed.* (Emphasis supplied). *Helvering v. Bliss*, 293 U.S. 144-151.

tion (Section 117, I.R.C. 1939 p. 28 *infra*) to the transaction under consideration, is not controlling as to the applicability of this section to the present transaction. It is not necessary, in order to hold that the respondent's assignment resulted in gain taxable as long-term capital gain, to hold that this instrument conveyed real estate or oil and gas in place. This is true because Section 117 applies to all property—realty, personalty, tangible or intangible—except the types of property specifically excepted from its operation by the terms of that section. These exceptions include "real property used in his trade or business," but paragraph (j) of the section extends long-term capital-gain treatment to the profit derived from the sale or other disposition of "real property used in his trade or business" and held for six months or more, while providing that a loss from the disposition of such real property should be treated substantially as an ordinary loss. So it is wholly immaterial here whether the interest disposed of by P. G. Lake, Inc. be treated as the disposition of real property or of some other type of property, since we are concerned only with a gain and not with a loss.

It can hardly be argued that the transaction did not come within the literal terms of Section 117. There was a sale of property. The property sold had been held for more than six months. The oil and gas leases from which the oil payment came were by stipulation not held primarily for sale to customers in the ordinary course of the company's business. It is not suggested—and it is not the case—that P. G. Lake,

Inc. customarily sold oil payments; so that the capital gain principles governing a real estate subdivider are not applicable to this isolated transaction.

There can be but two reasons advanced for refusing to treat the transaction under consideration as the sale of a capital asset. One of these, and the one relied upon by the Commissioner in asserting the deficiency involved, is that the transaction was the anticipatory assignment of income.[1] The other, based primarily upon *Corn Products Refining Company v. Commissioner*, 350 U.S. 46, is that the transaction, while meeting the letter, is not within the spirit of the capital-gain section.

The "assignment of future income" theory disregards the essential nature of the transaction. The principle would be more accurately stated if instead of naming it "assignment of future income" it were denominated the "assignment of future income only, with retention of the income-producing property." No one will seriously contend that capital-gain treatment is to be denied in the sale of income-producing property merely because the future income from the property will go with the property to the buyer. This is true regardless of how certain is the amount of the future income and how quickly it may be realized by the purchaser of the property. So, since, regard-

[1] The transfer is incorrectly classed as "temporary" in the petition for certiorari, p. 11. The transfer was permanent. The interest transferred, because of its nature, was of limited duration.

less of State law, an oil and gas lease is everywhere recognized as property, the question is, whether there was an actual sale of an interest in the property.[*] Since the Commissioner cannot argue that the sale of an unlimited overriding royalty carved out of a leasehold interest is not a sale of property producing capital gain, he is forced to the position that an unlimited overriding royalty is an interest in the property, while a limited overriding royalty is not. There is absolutely no authority for such a position. It cannot be supported by State law, as the opinion below amply demonstrates; nor, so far as we have been able to ascertain, is there a single judicial determination supporting his position. In fact, since *Ortiz Oil Company v. Commissioner*, 102 F. 2d 508, all of the authorities have been to the contrary.

Nor does reason, apart from authority, support such a distinction. One acquiring an unlimited overriding royalty acquires no more control over the property than does one acquiring a limited overriding royalty or oil payment. Neither bears any share of the expense of operating and producing oil or gas. Each is valuable only because of the oil and gas applicable to the interest which will be produced. In either case, but for the carving out of the limited or unlimited overriding royalty interest, the oil and gas applicable to that interest when produced would have been the ordinary income of the assignor. The Commissioner does not make the actual duration of the interest the

[*] If there was such a sale, it, of course, carried with it the future income of the interest sold.

criterion. Thus, the sale of an unlimited overriding royalty carved out of a leasehold whose probable future life was, say, two years, would be treated by him as the sale of a capital asset, while the carving out of an oil payment which might run eight or ten years would be treated as an assignment of future income only. This is an indefensible position, and every court to which it has been presented has refused to adopt it.

It is difficult to see how the Commissioner can draw any comfort from *Corn Products Refining Company v. Commissioner*, 350 U.S. 46. The taxpayer's contention there was that its transactions in corn futures were separate and apart from its business of manufacturing products from corn. But in the year considered, the company's dealings in corn futures amounted to 14,595,000 bushels, and not only did the Tax Court and the Court of Appeals find that the company's dealings in futures were "an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing requirements," but company officials testified that its dealings in corn futures were to fill an actual "need for the quantity of corn (bought) * * * in order to cover * * * what (products) we expected to market over a period of fifteen or eighteen months." Here was an extensive series of transactions, not only in the tax year but over a series of years, sufficient, entirely apart from the manufacturing business, of itself to constitute a business within the same rule that is applicable to the subdivision of real estate.

When considered in connection with the Company's manufacturing business it was nothing more than a part of the overall income from that day-to-day, year-to-year business. True, this Court said in the *Corn Products* case that Section 117 "must not be so broadly applied as to defeat rather than further the purpose of Congress," and that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss."[15]

But the sale made by P. G. Lake, Inc. was not in "the everyday operation of a business." It was an isolated transaction, as would have been the sale of its entire interest in any of its oil and gas properties. This conforms with the statement made by this Court in the *Corn Products* case that, "The preferential treatment provided by Section 117 applies to transactions in property which are not the normal source of business income."

Burnet v. Harmel, 287 U.S. 103, and *Watson v. Commissioner*, 345 U.S. 544, are likewise inapplicable. In the *Harmel* case, the contention was that the granting of an ordinary oil and gas lease was a sale within the purview of the capital-gain section of the Revenue Act of 1921, because Texas law classified the transaction as a sale even though it was not elsewhere so classified. The holding was that because the taxing

[15] But this Court also held that the capital gain section is not to be narrowly construed. *Helvering v. Bliss*, 293 U.S. 144-151.

act should be given a uniform, nationwide application, the classification of a transaction as a sale under State law would not control in the absence of an express Congressional direction that State law be the criterion of applicability. Similarly, in the *Watson* case, the fact that State law regarded a growing crop prior to harvest as a part of the real estate did not, in the absence of a Congressional direction to that effect, require that the portion of the consideration received for the sale of the property, including the rapidly maturing crop, prevent that portion of the consideration allocable to the crop from being treated as property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business and therefore excepted from the capital-gain section. It should be noted that in the *Watson* case this Court said:

> "We do not have here the situation which arises from the sale of land, including coal or other mineral wealth not separated from its natural state and not in the course of annual growth leading to a seasonal separation. * * * The instant case also is distinguishable from that of growing timber which is not in itself an annual or short-term product."

All that has heretofore been said as to the correctness of the result reached below is offered in amplification and not in derogation of the opinion below, which, we submit, fully supports and shows the correctness of the decision reached. We emphasize particularly what the Court below said upon the closely

related question of depletion. (pp. 81-82 petition for certiorari). An unavoidable result of the Commissioner's theory is a double allowance of depletion, contrary to *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312. The Commissioner would allow it to P. G. Lake, Inc. (see p. 7 *supra*), and *G.C.M. 24849* recognizes that the one acquiring the oil payment is entitled to an allowance for depletion as he receives income therefrom. (See pp. 36-38 *infra*).

3.

The Requisite Conflict Is Not Present

The Commissioner asserts a direct conflict with the decision of the United States Court of Appeals for the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901, and a conflict in principle with decisions of this Court. The decisions of this Court listed are *Burnet v. Harmel, supra; Corn Products Refining Company v. Commissioner, supra; Watson v. Commissioner, supra; Hort v. Commissioner*, 313 U.S. 28; *Harrison v. Schaffner*, 312 U.S. 579; *Helvering v. Clifford*, 309 U.S. 331; and *Commissioner v. Sunnen*, 333 U.S. 591.

We have heretofore dealth with the first three of the cases by this Court so listed. The Commissioner himself sufficiently distinguished the question dealt with in the other cases from that here involved when in *G.C.M. 24849* (Appendix, p. 39, *infra*) it was said:

> "The issue presented by such assignments of expected income between strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as *Lucas v. Earl*, 281 U.S. 111; *Helvering v. Horst*, 311 U.S. 112; and *Helvering v. Eubank*, 311 U.S. 122, involving donative assignments of income by the earner thereof, in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization."

This quotation is all the more pertinent because it comes from the very ruling which provoked the present controversy.

The assertion of a direct conflict with the *Slagter* case as a basis for granting the writ applied for, is unusual in that the Commissioner repudiates that decision and would be the last to ask this Court to apply it to the case under consideration.

The facts in the *Slagter* case show that Slagter had been running oil produced from several leaseholds to Ashland Oil & Refining Company. Being in need of funds, he obtained $501,000 from Ashland and executed an instrument which entitled Ashland to 60% of his share of the oil thereafter to be produced, until it (Ashland) had received oil of the value of $513,000. Slagter also undertook in the selfsame transaction, to run his remaining 40% of the oil to Ashland and, to the extent he could control associated interests, to

cause these associated interests also to run and sell their oil to Ashland. There was no personal obligation on the part of Slagter to repay any part of the $501,000, Ashland agreeing to look only to the specified share of the oil for the recoupment of the money paid. The Commissioner treated the transaction as producing $501,000 of depletable ordinary income to Slagter when that amount of money was received by him. Slagter contended that this amount was the consideration received for an interest in his properties sold to Ashland, and, other statutory provisions being met, that he was entitled to have the resulting gain taxed as long-term capital gain. The Tax Court affirmed Slagter's position, but upon the Commissioner's petition for review, the Seventh Circuit Court held that the absence of a personal covenant or obligation to repay the money obtained from Ashland did not prevent the payment from being a loan from which Slagter received no income whatsoever but merely pledged 60% of his future production to the repayment of the loan. As applied to the *P. G. Lake, Inc.* case, since the transaction was consummated in 1950 (the tax year here involved) but the conveyance was effective at 7:00 a.m. January 1, 1951, the principle of the *Slagter* case would require a holding that P. G. Lake, Inc. received no income at all from this transaction in 1950 but is entitled to a refund of the capital-gain tax which it paid. This obviously is not the result which the Commissioner seeks to obtain from a review by this Court of the *Lake* case.

This analysis of the *Slagter* case throws light on the observation in the petition for certiorari (footnote 7, p. 13) that, "While we believe that the Seventh Circuit reached the correct result on the nature of the income, it reached a doubtful result on the question of when the income was realized." What the Seventh Circuit actually held as to the "nature of the income" was that there was no income received when Slagter received the $501,000, just as there would not have been had he given his promissory note to a bank for that amount secured by his oil properties. The further holding of the Court in *Slagter* was that when, after obtaining the money, oil was produced from the Slagter properties, the proceeds from this oil constituted his ordinary income from the properties involved. Under this theory, the difference between the $501,000 received by Slagter, and the $513,500 which Ashland was to receive and did receive, was a payment in the nature of interest.

We are not advised as to whether there is anything in Illinois law (in which state the Slagter properties were located) which induced the holding that an advance with no personal obligation to repay, made in consideration of the grant of an interest in property, is a loan,—but it is quite clear that the Commissioner's repudiation of the result reached in the Slagter case is not the first time that he has denied the applicability of the loan theory to such a transaction. In *Ortiz Oil Company v. Commissioner*, 37 B.T.A. 656, 102 F. 2d 508, cert. den. 308 U.S. 566, the taxpayer urged that a similar transaction was a loan, while the Commis-

sioner originally contended that it produced ordinary depletable income. The Board of Tax Appeals held that neither was right, but that the transaction was a sale of an interest in the property. When the case reached the Fifth Circuit, the Commissioner successfully defended the Board's holding, and this Court denied certiorari.

It may be fairly said that the *Slagter* case holds only that a somewhat similar transaction, with different and perhaps distinguishing features, is not a sale either of property or of "future income," but, under the peculiar circumstances, a loan. In no event can it be said that the *Slagter* case is a holding which the Commissioner of Internal Revenue will ask this Court to follow. This, we submit, is not the type of conflict which this Court had in mind in adopting its existing rules regarding the granting of a petition for certiorari.

CONCLUSION

For all of the foregoing reasons, it is respectfully submitted that the petition for certiorari should be denied.

Respectfully submitted,

Harry C. Weeks
525 Fort Worth National
Bank Building
Fort Worth, Texas

Attorney for P. G. Lake, Inc.,
Respondent

APPENDIX

Internal Revenue Code of 1939:

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income:

(10) *Net capital gain.*—

* * * *

(A) Corporations.—In the case of a corporation, the term "net capital gain" means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges; and

(B) Other taxpayers.—In the case of a taxpayer other than a corporation, the term "net capital gain" means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus net income of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from such sales or exchanges. For purposes of this subparagraph, net income shall be computed without regard to gains or losses from sales or exchanges of capital assets. If the tax is to be computed under Supplement T, "net income" as used in this subparagraph shall be read as "adjusted gross income."

* * * *

(c) *Alternative Taxes.*—

(1) *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 13, 14, 15, 204, 207(a)(1) or (3), 421 and 500, a tax deter-

mined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of such excess, except that in the case of any taxable year beginning after March 31, 1951, and before April 1, 1954, there shall be ascertained an amount equal to 26 per centum of such excess.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

(j) *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purpose of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, held for more than 6 months, and

real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power or imminence thereof) of property used in the trade or business and capital assets held for more than

6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * *

(3) *Sale of land with unharvested crop.*—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted as described in paragraph (2)) at the same time and to the same person, the crop shall be considered as "property used in the trade or business".

* * * *

Sec. 23(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if

the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

* * * *

Sec. 114(b)(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

G.C.M. 24849

Consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

An opinion is requested with respect to the status, for Federal income tax purposes, of cash payments to owners of depletable economic interests in oil and gas in place as consideration for assignments of in-oil rights carved out of the economic interests held by them. Such rights entitle the assignee to oil or gas produced, or the proceeds derived from an agreed share of production if, as, and when produced, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received. Such rights ordinarily pay out and expire within one or two years.

G.C.M. 22730 (C.B. 1941-1, 214) deals with the issue only to the extent of distinguishing the case in which an operator assigns an in-oil payment right in return for cash which he is pledged to use in the development of the property (in which event such cash payment is not income to the assignor and its use for the pledged purpose is not regarded as an expenditure by the assignor) from the instant case which involves

an outright purchase of an in-oil payment right for cash "wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold." This statement, made parenthetically in G.C.M. 22730, supra, at page 222, was not enlarged upon there. Consideration must now be given to the Federal income tax effect, in the case of the assignor, of a transaction wherein he receives unqualifiedly a cash payment for an in-oil payment right. Is such cash payment ordinary income or proceeds from the sale of a capital asset? If it is the latter, the capital gain is measured by the cash payment less the allocable part of the basis of the assignor-operator in the oil and gas in place, plus the estimated cost to him of producing the oil involved in the oil payment right—an obligation he assumes without further cost to the assignee.

G.C.M. 22730, supra, recognizes that the holder of an in-oil payment right, however acquired, has a depletable economic interest in the oil and gas in place, which is potentially a capital asset in his hands, provided the conditions of that classification under section 117 of the Internal Revenue Code are met. Such conclusions as to the status of the in-oil payment right in the hands of the grantee are not determinative of the nature of the transaction in the case of the grantor. As pointed out in the cited opinion, the controlling

decisions hold that a landowner who grants a lease, or a lessee who subleases or assigns his lease, in consideration of a cash bonus payment and an agreement to pay stipulated royalties is taxable on all such payments as ordinary income. In such a case, the cash bonus payment is regarded as an advance royalty payment subject to the depletion allowance as respects the lessor or sublessor, though it represents a capital investment by the lessee or sublessee in oil and gas in place, returnable tax-free to him by way of depletion deductions spread over the productive life of the lease asset in his hands. That conclusion rests on the analogy between the receipt of such advance royalty payments and substantial cash payments received by the lessor upon the execution of an ordinary lease, which payments are regarded as advance rental payments taxable as ordinary income. Thus, in connection with the instant issue, as in the cited opinion, the fact that the assignee acquires an asset which potentially qualifies as a capital asset in his hands does not require the conclusion that the assignor parted with such an asset.

In-oil payment rights, royalty rights, and operating rights are analogous in that they are essentially rights to production income characterized as ordinary income when realized. All are regarded as depletable economic interests in oil and gas in place entitling the owner to tax-free return of his investment through the depletion allowance. In-oil payment rights are distinguishable from royalty interests and operating

rights in that the latter interests, by definition, extend to the entire oil and gas resource content of the land, and, as such, represent forms of fractional property rights into which the property interests in oil and gas in place are commonly divided, whereas an in-oil payment right is a right to income for a limited time or amount. This difference is emphasized by the fact that an in-ol payment right may be carved out of either of the specified property interests in oil and gas in place, but the reverse is not true. Thus, sales of royalty rights or operating rights are sales of property rights, whereas assignments of in-oil payment rights carved out of such property rights, are, with respect to the assignor, essentially mere assignment of expected income from such property rights for a fixed or determinable period of time.

The issue presented by such assignments of expected strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as *Lucas v. Earl* (281 U. S., 111), *Helvering v. Horst*, (311 U.S., 112, Ct. D. 1472, C.B. 1940-2, 206), and *Helvering v. Eubank* (311 U.S., 122, Ct. D. 1473, C.B. 1940-2, 209), involving donative assignments of income by the earner thereof in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization. See *Herman M. Rhodes v. Commissioner* (43 B.T.A., 780, affirmed, 131 Fed. (2d) 50), wherein the United States Board of Tax Appeals (now The Tax Court of

the United States) held that a stockholder's "exercise of his power to sell or assign his right to receive the declared dividend constituted a realization of income by petitioner (stockholder) taxable to him as ordinary income."

In principle the assignment of a right to a dividend seems indistinguishable from assignments of other rights to expected income. Assignments of income rights by the earner for cash or property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has elected to anticipate normal realization by assigning or discounting such right. Consideration received by him represents ordinary income realized by him upon the anticipatory assignment of his right to income. Once such rights to income from property or for services are separated from the earner by his act of assignment, they become property rights owned by the purchaser or assignee with a basis in his hands measured by the consideration paid. Thus, any discounting of the face value of the income right or claim by the earner thereof upon the assignment will result in income to the assignee when such discount is realized by him.

The stated general rule with respect to anticipatory assignments of income for cash or property seems equally applicable to assignments of income arising from royalty or operating property rights in oil and

gas in place. As noted above, the characterization of a transaction as a purchase in the case of the assignee is not inconsistent with treating it as a mere anticipatory realization of ordinary income to the earner. That is true under the general rule pertaining to such assignments as well as to cases of grants of depletable interests in oil and gas in place for advance royalty payments made to obtain such grants under oil and gas leases. Similarly, it is immaterial that the assignment of income vests a depletable right in the assignee. The right to depletion, as such, is not transferred. The assignor, on receipt of the anticipated income thereby realized, is entitled to the depletion allowance which is designed to compensate him for the diminution in his interests sustained by the conversion of capital into ordinary income thereby affected. Thus, qualification of the assigned right as a depletable right in the hands of the assignee springs from the character of the right rather than from the transfer. To the extent that there is a shift of depletable interest, it is analogous to the corresponding shift resulting from a cash bonus or an advance royalty payment made to obtain an oil and gas lease. In both instances, the assignor or grantor is entitled to a depletion allowance which attends the income thereby realized by him, and the assignee, in both instances, acquires a depletable economic interest in oil and gas in place.

For the reasons stated, it is the opinion of this office that consideration (not pledged for development)

received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands. No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue

I.T. 4003

Assignments of in-oil payment rights

Advice has been requested with respect to the phrase "short-lived in-oil payment rights," as used in G.C.M. 24849 (C.B. 1946-1, 66) and I.T. 3935 (C.B. 1949-1, 39).

G.C.M. 24849, supra, expresses the opinion that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income to the assignor unless such consideration is pledged for use in further development. As a precaution, pending further consideration of the feasi-

bility of distinguishing between short-lived and long-lived in-oil payment rights, the statement was made in G.C.M. 24849 that: "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved."

After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

Notwithstanding the foregoing, G.C.M. 24849, *supra*, and I.T. 3935, *supra*, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property.